6

No. 2777

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

THE GOLDFIELD CONSOLIDATED MINES COMPANY (a corporation),
Plaintiff in Error,

vs.

JOSEPH J. SCOTT, as Collector of Internal Revenue, Fourth California District,
Defendant in Error.

BRIEF FOR PLAINTIFF IN ERROR,

Upon Writ of Error to the United States District Court of the Northern District of California, Second Division.

HOYT, GIBBONS & FRENCH,
ALLEN G. WRIGHT,
Attorneys for Plaintiff in Error.

Filed
SEP 22 1916
F. D. Monckton,
Clerk.

Filed this..........day of September, 1916.

FRANK D. MONCKTON, Clerk.

By..........Deputy Clerk.

PERNAU PUBLISHING COMPANY

No. 2777

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

The Goldfield Consolidated Mines Company (a corporation), *Plaintiff in Error,* vs. Joseph J. Scott, as Collector of Internal Revenue, Fourth California District, *Defendant in Error.*	}

BRIEF FOR PLAINTIFF IN ERROR,

Upon Writ of Error to the United States District Court of the Northern District of California, Second Division.

Statement of the Case.

The writ of error herein, in which the Goldfield Consolidated Mines Company, a corporation, is plaintiff in error, and Joseph J. Scott, as Collector of Internal Revenue, Fourth California District, is the defendant in error, comes to this Court in the following manner:

The plaintiff in error filed and served its complaint in June, 1914 (Transcript, pages 1-15 inclu-

sive), in which it is stated that the predecessor of this defendant in the office of Collector of Internal Revenue levied a tax for the year 1909, against the plaintiff in error of forty-one thousand, eight hundred and ninety and 91/100 ($41,890.91) dollars, being one (1%) per cent of the total net production of the plaintiff in error for that year, such net production being four million, one hundred eighty-nine thousand, ninety-one and 61/100 ($4,189,091.61) dollars; that said levy was based upon an assessment which denied a claimed deduction of the value in the ground before it was mined of the 230,463 tons of ore mined in the year 1909, which constituted an exhaustion of the capital value of the property owned by the plaintiff in error; that the assessment and levy and payment of the tax were all duly protested; that thereafter on August 2, 1911, the plaintiff in error, in compliance with the Statutes of the United States (Revised Statutes 3220 and 3226) filed its claim for refund of said taxes erroneously collected, the claim being based upon the same grounds as the protests mentioned; that during the pendency before the Commissioner of Internal Revenue at Washington of the said claim of refund, the plaintiff in error appeared by its authorized officials in person before the Commissioner of Internal Revenue and there made full explanation and offered full proof of the correctness in all respects of its return of net income for the year 1909, and stated its reasons in support of said claim of refund, and during the pendency and consideration of said claim by the

Commissioner of Internal Revenue, the plaintiff in error was granted until and including the 24th day of January, 1912, within which to comply with the rules and regulations of the Treasury Department, and with further requirements of the Commissioner; that within the time so given, the plaintiff in error in full compliance with the rules and regulations and additional requirements imposed, submitted an amended return in which was ascertained and stated the unit cost per ton and resulting value as of January 1, 1909, of the tons of ore mined, and showed both in said return and in its own records and published official statements, a resulting deduction for depreciation in the sum of three million seven hundred and seventy thousand, three hundred and seventy-four and 68/100 ($3,770,374.68) dollars, which with other legal deductions resulted in and showed the net income for that year to be seven hundred sixty-five thousand three hundred eighty and 02/100 ($765,380.02) dollars, which showing is alleged in the complaint to be correct and true in all respects; the complaint further showed that in disobedience and disregard of the law, the rules and the regulations, the Commissioner disallowed and refused to recognize the claim and appeal of the plaintiff for the refund of said tax or any part thereof; the complaint further shows that the disallowance and denial of the Commissioner was communicated by the Collector of Internal Revenue and due notice given to the plaintiff in error and that no part of said tax of forty-one

thousand eight hundred ninety-one and 91/100 ($41,891.91) dollars, has been refunded or paid back, and the same is still due and unpaid.

The second cause of action contained in the complaint was for the year 1910, and is substantially in all respects like the first cause of action with the exception of the different amounts in tonnage and money, the tax collected for the year 1910, being forty-nine thousand, six hundred eighty-one and 02/100 ($49,681.02) dollars, based upon a net realization for that year of ~~seven million, four hundred~~ four million, nine hundred sixty eight, ~~14/100~~ thousand, one hundred two and 45/100 ($4, 968,102.45) d payment of the tax having been in like manner protested and statutory application for refund made, and during the pendency of the application for refund before the Commissioner of Internal Revenue, a like showing, amended return and resulting depreciation of four million, five hundred forty-five thousand, six hundred ninety-one and 44/100 ($4,545,691.44) dollars being shown, resulting with other legal deductions in a net income subject to the tax of four hundred twenty-eight thousand, four hundred fifty-nine and 97/100 ($428,459.97) dollars; the complaint further showed the disallowance, denial and notice thereof through the collector to the plaintiff in error.

To this complaint, the above statement of which is of course a brief summary, the defendant in error demurred, and to each cause of action therein stated, which demurrer was sustained and judgment of

dismissal entered December 29, 1915 (Transcript, pages 20-22 inclusive). Thereafter a bill of exceptions was duly filed (Transcript, pages 25-29 inclusive), petition for writ of error and other formal proceedings taken (Transcript, pages 30-34 inclusive), assignment of errors (Transcript, pages 34-37 inclusive), order allowing writ of error and bond on writ of error (Transcript, pages 38-41 inclusive), and citation and writ of error issued March 27, 1916 (Transcript, pages 45-48 inclusive).

The errors assigned are brief and for the convenience of the Court we hereby specify the following errors upon which we rely:

SPECIFICATION OF ERRORS RELIED UPON.

I.

That the said District Court erred in sustaining the demurrer of the defendant to the complaint of the plaintiff on file herein upon the grounds set forth in said demurrer.

II.

That the said District Court erred in sustaining the demurrer of the defendant to the first count of said complaint upon the grounds set forth in said demurrer.

III.

That the said District Court erred in sustaining the demurrer of the defendant to the second

count of said complaint upon the grounds set forth in said demurrer.

V.

That said District Court erred in dismissing said action.

VI.

That said District Court erred in ordering and entering judgment in favor of the defendant in said action.

VII.

That said District Court erred in not giving, making and entering its order in said action overruling said demurrer to said complaint and to each of the counts thereof.

VIII.

That said District Court erred in not overruling the demurrer to the plaintiff's complaint and to each count thereof, inasmuch as it appeared from said complaint, and from each count thereof, that the plaintiff had complied with all the regulations and requirements of the Treasury Department governing and ascertaining of lawful deductions from gross income; that the said regulations were in all respects in accordance with law, and under the law and the regulations the deductions claimed were legal and should not have been disallowed.

It will be seen that the question presented to this Court, though perhaps difficult of solution, is after all a very narrow question which can be simply stated: Is a mining corporation under the Corporation Excise Act of August 5, 1909, entitled, in the ascertainment of its net income to a deduction against gross proceeds from the mining and treatment of ores, to the extent of the ascertained purchase cost value of the ore in the ground before it was mined? We employ the expression "purchase cost value" rather than the term "value" in order at the outset to inform this Court that our claim for the refund of the taxes paid is limited strictly to the amounts which result from the application of the government regulations hereinafter explained and referred to.

What is claimed by us in this proceeding is that the plaintiff in error is entitled to deduct the *cost* of each ton of ore from the net realization therefrom in the calculation of net income, for the reason that the ton of ore was a part of the company's capital assets and is forever destroyed and its assets proportionately impaired to the extent of that ton of ore. In this contention we think it must be plain that we surely ask no more than what is reasonable. Our grievance is, that the plaintiff in error was not permitted any deduction whatever.

For the purposes of consideration of this case we here repeat in brief form for the convenience of the Court and counsel the precise figures upon which we make this contention: The taxes levied and paid were

for the years 1909 and 1910. The amended showing before the Commissioner of Internal Revenue was based upon the most careful calculations so that in these two years which constituted the hey-day of the company's prosperity the cost value of the ore mined in 1909 was $3,770,374.68 leaving as net income under the Treasury rules and regulations in force $765,380.02 so that the tax for that year should have been $7,653.80 instead of $41,890.91 which was paid. The cost value of the ores mined in the year 1910 was $4,545,691.44 leaving as net income under the Treasury Department rules and regulations for the year 1910, $428,459.97 so that the tax for that year should have been $4,284.60 instead of $49,681.02 which was paid.

Argument.

PRELIMINARY.

This proceeding involves an important question as to what deductions may be made by a mining corporation from its gross production in order to ascertain its net income within the meaning of the Corporation Excise Tax Law enacted August 5, 1909. In the interest of clearness and to avoid so far as possible confusion of thought in the solution of a complex question, we have thought it best to preface the formal points and authorities of the case by these preliminary remarks.

An examination of the few authorities bearing upon this question of depreciation will disclose the fact that before the Treasury Department had finally formulated its rules and regulations governing the assessment of the taxes against mining corporations and other corporations engaged in a business involving what is known as "wasting assets," corporations engaged in the business of mining metals, coal companies, oil producing companies, lumber companies and industries of that character conceived it to be obvious that the operations carried on by them necessarily involved the physical destruction of the capital assets upon which depended the life of the industries in which they were engaged. At first these companies took the position, in making returns under the Corporation Excise Act, that they were respectively entitled to a deduction equal to the value in the ground before it was mined of the ores, oils, and mineral contents, also of standing trees, etc., and that their income, if any, would be such profits or gains as could be shown over and above the value of capital assets thus used up. Thus many companies went so far in their claims for deductions as to urge that in the nature of things, there could be no profits or gains within the meaning of an income tax law for the reason that the only means of ascertaining the value of ore in the ground before it was mined, would be to calculate the difference between the gross realization therefrom and the costs of production. This

position, if it had been sustained, would of course have absolved these companies from the payment of any tax whatever. The only case which has reached the Supreme Court of the United States and has been determined by that Court was one in which the company relied strictly upon this position, and the Supreme Court declined to adopt such a sweeping view and therefore sustained the assessment which had been attacked; at the same time, however, that Court recognized that such a company is entitled to proper deductions for such depreciation in its capital assets, and three members of the Court believing that the company was entitled to the whole deduction claimed, dissented from the ruling made.

It is not our purpose in these preliminary remarks to analyze the decisions thus far rendered which we will show are in favor of the view herein expressed. But we desire to show in this part of our brief the growth and development of the ideas which at present obtain. The Treasury Department, after patient study of the economic aspects of the problem finally promulgated its regulations, which are hereinafter more fully set forth, and the theory adopted by the Treasury Department as embodied in the regulations upon the subject, made a distinction between gains from the sale of capital assets and commercial gains arising from skillful and efficient conduct of the business. In the ascertainment of gains from capital assets they adopted the rule of sub-

tracting from the gross realization from such sales, the purchase cost of the tons of ore, barrels of oil, or other units, making suitable allowance by addition or subtraction to represent increase or decrease of the value of these units prior to January 1, 1909, the date when the law retroactively took effect, and the Department in these regulations, with painstaking accuracy pointed out the mode by which the calculations should be made so that the deduction for this kind of depreciation would be represented by the resulting cost per ton multiplied by the number of tons extracted in any year.

We do not say that these regulations were necessarily the best possible solution of the difficult problem which faced the Department, but we do say that they were at least *more than fair* to the government and *less than fair* to the operator. These regulations have never been disapproved by any Court (unless the order sustaining the demurrer in the case at bar should be regarded as such disapproval), and we will show herein by the cases cited and discussed that the present condition of the law fully sustains our contention that we are entitled to the deductions claimed in our complaint.

Points and Authorities.

I. THE CORPORATION EXCISE TAX LAW BEING SECTION 38 OF THE ACT APPROVED AUGUST 5, 1909, PURPORTS ONLY TO LEVY UPON A CORPORATION AN EXCISE TAX "EQUIVALENT TO ONE PER CENTUM UPON THE ENTIRE NET INCOME OVER AND ABOVE $5,000, RECEIVED BY IT FROM ALL SOURCES DURING SUCH YEAR", AND THE ACT AS CONSTRUED PERMITS DEDUCTION FOR ORES EXHAUSTED IN MINING.

In the beginning and before the Treasury Department and the Courts had had time to rule and pass upon the Act in question, many corporations were of the opinion supported by very respectable authority that there was a clear distinction between what constitutes capital and what constitutes income, Gray v. Darlington, 15 Wall 63; 21 Law Ed. 45; and that the ore in a mine is merely a part of a company's capital assets.

Sargent Land Co. v. Von Baumbach, 207 Fed. 423;
Mitchell Bros. Co. v. Doyle, 225 Fed. 437.

It was upon this principle that the first cases coming to the attention of the Courts were based.

United States v. Nipissing Mines Co., 202 Fed. 803;
Stratton's Independence Ltd. v. Howbert, 207 Fed. 419;
Sargent Land Co. v. Von Baumbach, 207 Fed. 423.

In these cases it will be observed that the contending companies did not attempt to analyze accounts

so as to ascertain depreciations from exhaustion under the *cost* basis but stood strictly upon the proposition that the yield of a mine was necessarily from the sale of its capital assets and therefore not income, and it will be found that in the first and third of the cases cited, even that contention was sustained by the Courts. In the second of the cases, however, an opposite view was entertained and the Circuit Court of Appeals for the Eighth Circuit, when the case came to it on writ of error, certified to the Supreme Court of the United States certain questions involved.

Stratton's Independence Ltd. v. Howbert, 231 U. S. 399; 58 Law Ed. 285.

The United States Supreme Court in its determination of the correct answers to the questions so certified found itself limited by the record to the strict answer to the questions as certified and therefore found that the mining company was not entitled to deduct the whole net realization from ores as claimed by the company as the measure of the value of the ore in place. But the Court was careful to state in numerous parts of its opinion that it was driven to this conclusion by the condition of the record and the form of the questions submitted.

The Court said at page 421:

> "It was of course contemplated that the income might be derived from the employment of property in business, and that this property might become more or less exhausted in the process; and because of this, a reasonable al-

lowance was to be made for depreciation if any."

Again, at page 417:

"Congress no doubt contemplated that such corporations amongst others, were doing business with a wasting capital, and for such wastage they made due provision in declaring that from the gross income there should be deducted (inter alia) 'all losses actually sustained within the year,' including 'a reasonable allowance for depreciation of property, if any,' etc."

But the Court put the seal of its condemnation upon the claim to deduct the full net value in these words, at page 420:

"And so, an affirmative answer to the third question as propounded would be the same in effect as an affirmative answer to the first or the second. For it is a matter of little moment whether it is to be said (a) that mining corporations are not 'engaged in business' at all, or (b) that they are engaged in business, but the proceeds of ore mined are not income, or (c) that such proceeds are income, but that there must be allowed as depreciation *all that part of the proceeds which remains after paying the bare outlays of the business.* In either case mining corporations would be exempt from the tax."

And at the conclusion of the opinion, page 422, we find the following:

"It would therefore be improper for us at this time to enter into the question whether the clause, 'a reasonable allowance for depreciation of property, if any,' calls for an allowance on that account in making up the tax, where no depreciation is charged in practical bookkeep-

> ing; or the question whether depreciation, when allowable, may properly be based upon the depletion of the ore supply estimated otherwise than in the mode shown by the agreed statement of facts herein; for to do this would be to attribute a different meaning to the term 'value of the ore in place' than the parties have put upon it, and to instruct the circuit court of appeals respecting a question about which instruction has not been requested, and concerning which it does not even appear that any issue is depending before that court."

From these excerpts and others which might be quoted it is plain that the Court has conceded that a depreciation allowance from exhaustion is proper if based upon a fair and reasonable basis, and all that the Court decided is that it would not do for a corporation to claim as deduction the whole net realization and thereby escape the payment of the tax. It is obvious that if the complaining corporation in that case had proceeded in the manner in which the plaintiff in error in the case at bar proceeded, the decision must necessarily have been in its favor, but having relied upon a claim to deduct the whole net yield, and the record coming before the Court in that form, the Court was obliged to deny the claim and had before it no means or data upon which to base a more favorable decision. It will be noted that Mr. Chief Justice White, Mr. Justice McKenna and Mr. Justice Holmes dissented from the answer to the third question, even in the face of the record as it was made.

Since the decision of the above mentioned cases there have been two more Court decisions to which we respectfully direct attention.

The case of Von Baumbach v. Sargent Land Company (207 Fed. 423), was affirmed by the Circuit Court of Appeals of the Eighth Circuit, 219 Fed. 31. In the course of the opinion by Circuit Judge Sanborn, we find the following:

> "There are still other reasons than those which have been stated why the judgments below should not be reversed. If there were error in the conclusion that the receipts of the companies from their collections of the amounts of their claims against the lessees which came due in 1909, 1910 and 1911, for the purchase price of or the royalties on the ore were not included in their gross income, if they were a part of that gross income, then the companies would have been entitled to 'a reasonable allowance for depreciation of property' by the reduction of the values of their claims by these payments. Stratton's Independence Limited v. Howbert, 231 U. S. 399, 418; 34 Sup. Ct. 136; 58 L. Ed. 285. And as the payments on these claims unavoidably reduced and depreciated their value, as has been shown, by the amounts paid, there would have been no net income from them on account of which an excise tax could have been lawfully exacted. United States v. Nipissing Mines Co. (D. C.), 202 Fed. 803, 805; Stevens v. Hudson's Bay Co., 101 L. T. Rep. 96, 97, 98."

This is in strict harmony with what had been said by District Judge Willard in the original trial of the case, 207 Fed. 423, at page 430:

> "I believe that the ordinary meaning attached to income, when it is not derived from personal

> exertion, is that it is something produced by capital without impairing that capital, and which leaves the property intact, and that nothing can be called income, for the purpose of this act, which takes away from the property itself."

In Mitchell Bros. Co. v. Doyle, 225 Fed. 437, these principles were invoked by a lumber company which in computing its taxable net income for the years 1909 and 1910 and other years deducted from its gross receipts the then actual market value of the timber stumpage cut and converted into lumber during the respective years. After payment upon that basis the Commissioner of Internal Revenue had made an additional assessment for each year based upon the prices paid by the plaintiff in 1903 for its timber, lands and other property as shown upon its books. These additional excise taxes were paid under protest and suits brought to recover the amounts paid. It was shown that between 1903, the date of purchase and January 1, 1909, the date when the Excise Tax Law went into effect, these lands and the timber thereon had so increased in value that they were fully worth the amounts which had been originally deducted from the gross receipts as capital assets. The Court said:

> "It cannot be denied that the plaintiff's standing timber was a part of its capital assets, and that the conversion of the timber into lumber and the sale of the lumber constituted at least an indirect sale of the timber, and so of capital assets. The mere change of the timber into lumber or money did not transform capital

into income. The miller who grinds his stock of wheat into flour and sells the flour does not thereby destroy or impair his capital and convert it into income. The same is true of the manufacturer who converts his cotton into cloth, the landowner who sells his lands for cash, the furniture maker who transforms lumber and other material into chairs and tables, the ironmaker who produces steel rails from iron ore, and every industrial institution where raw materials are converted into finished or other products or into money. In each instance, income is and must be something over and above the original capital investment plus the cost of production and sale. This rule has been uniformly recognized by the Commissioner of Internal Revenue in the decisions and directions issued from his office for the guidance of the collectors of corporation excise taxes and of the taxpayers themselves.

Standing timber is as staple a product as wheat, cotton, or iron. It is a tangible and visible property, whose quantity, quality, and market value can be readily ascertained and determined. In these respects it is wholly unlike mineral ores in place under ground. If plaintiff had sold its standing timber on the 1st day of January, 1909, at its market value, could it be claimed that any part of the proceeds of such sale constituted taxable income, because more was realized than the original cost in 1903? Certainly not, for the reason that the increase in value had accrued prior to the time when the Excise Tax Law became operative. If plaintiff had purchased its timber 30 years ago from the government at $1.25 per acre, and had manufactured all of it into lumber and sold the lumber during the year 1909 at market prices which prevailed on the first day of that year, could it be claimed that the entire proceeds of the lumber above the trifling purchase

price of the timber and the cost of manufacture and sale constituted taxable net income? Can the government, at least in the absence of specific legislative declaration to that effect, reach back years before the enactment of its revenue statute for a controlling factor in determining the net income of a corporation? Can it ignore a substantial increase in value of property, which has occurred and accrued prior to the taking effect of the tax law, and thereby convert into income that which is not income within any meaning of the term? To state these questions is to answer them. Gray v. Darlington, 15 Wall. 63; 21 L. Ed. 45; Bailey v. Railroad Co., 106 U. S. 109, 114, 115; 1 Sup. Ct. 62; 27 L. Ed. 81.

The rule of apportionment of the increment or increase of values between the years prior to January 1, 1909, and those subsequent to that time, which has been recognized and acted upon by the Commissioner of Internal Revenue, does not aid the government in this case, for the reason that the amounts deducted by plaintiff from its gross receipts as capital assets did not exceed the actual market value of its property upon January 1, 1909. It makes no difference whether such deduction was made nominally on account of depreciation of property or for restoration of capital.

Tested by another well-settled rule that the gain, profit, or income of a corporation is that which may be withdrawn or expended without reducing the value of its property or impairing its capital, the contentions of the government must fail. Every tree cut from the lands of plaintiff after January 1, 1909, and manufactured into lumber, cord-wood, or other products, and then sold, reduced its property and capital by the exact amount of the value of such standing tree, unless an equivalent portion of the proceeds of the sale was substituted therefor.

> The government is not concerned with the gains made, profits earned, or income received, whatever their form, by the plaintiff prior to the time when its tax law became operative. Whether a valid retro-active law could be enacted need not be determined, because no attempt has been made to tax such gains, profits, or income."

We have thus liberally quoted from this case because we believe sincerely that the legal principles therein stated are both sound and conclusive of the case at bar. We further believe that every one of the principles therein stated are in precise harmony with the Supreme Court's decision in Stratton's Independence Limited, and that it is only by a misreading of the Stratton's Independence Limited case that a different conclusion could be reached. In all these cases the right to a deduction of such value as the ore or the timber respectively had when the law went into effect January 1, 1909, are clearly recognized and the only reason why the Supreme Court could not grant relief to the complainant in the Stratton's Independence Limited case was because that particular plaintiff had made and flatly stood upon and persisted in an unwarranted and unjustifiable demand that it should be relieved from taxation altogether. All that was decided by the Court, as already stated (and for this reiteration we humbly apologize) was that it was unjustifiable to treat the whole net realization as the precise measure of the value of the ore in place. There was no question before that Court of what

would be the effect of compliance with the Treasury Department regulations hereinafter referred to; there was no attempt on the part of the complaining company in that case to comply with any Department regulations for the ascertainment of the cost value. That Court was therefore, as stated in its opinion, not called upon to pass upon

> "The question whether depreciation, when allowable, may properly be based upon the depletion of ore supply estimated otherwise than in the mode shown by the agreed statement of facts herein; for to do this would be to attribute a different meaning to the term 'value of the ore in place' than the parties have put upon it, and to instruct the Circuit Court of Appeals respecting a question about which instruction has not been requested, and concerning which it does not even appear that any issue is depending before that Court."

It is for this reason that we strenuously urge that this case is not governed at all by the ruling in the Stratton's Independence Limited case. The Honorable District Court did, however, sustain the demurrer herein upon the authority of that case (Transcript, page 23) but we respectfully maintain that this conclusion must have sprung from a misconception of the situation involved therein.

II. THE TREASURY DEPARTMENT REGULATIONS WERE REASONABLE AND LAWFUL; THE PLAINTIFF IN ERROR COMPLIED THEREWITH AND IS THEREFORE ENTITLED TO THE DEDUCTIONS CLAIMED AND TO REVERSAL OF THE JUDGMENT ACCORDINGLY.

Upon the authority of all these cases above cited, we deem it clearly to be established that the plain-

tiff in error herein was entitled to recover the bulk of the tax paid upon some proper basis of depreciation for exhaustion of capital assets. The only remaining question as it seems to us, is, what is the true basis of allowance for depreciation of ore bodies in a mine?

This brings us to a consideration of the regulations of the United States Treasury Department to which Department is confided by law the administration of the Act under discussion.

The first regulation upon the subject was promulgated December 3, 1909, and employed very general language. It is as follows:

> "DEPRECIATION—The deduction for depreciation should be the estimated amount of the loss, accrued during the year to which the return relates, in the value of the property in respect of which such deduction is claimed that arises from exhaustion, wear and tear, or obsolescence out of the uses to which the property is put, and which loss has not been made good by payments for ordinary maintenance and repairs deducted under the heading of expenses of maintenance and operation or in the ascertainment of gross income. This estimate should be formed upon the assumed life of the property, its cost value, and its use."

Then followed the regulations of February 14, 1911, known as T. D. 1675, in which the Department, after long study, aimed to reach a solution of this question which would be fair to the government and to the mining companies. We will cause to be printed an appendix to this brief containing the

part of the regulations applicable to the question under discussion, being Sections 80-89 inclusive, and in our brief we will attempt only to set out the plan thereof in substance.

The Regulations, Sections 80 to 89 inclusive, relate to depreciation of minerals, oils, etc.: they divided gains and profits of business involving wasting assets into two classes (a) gains from sale of capital assets and (b) commercial gain from skillful and efficient conduct of the business; they base the scheme of ascertainment of *net* income in such business primarily upon the "original capital investment cost" making suitable addition for increase of value prior to January 1, 1909, when the law took effect retroactively, this element being regarded as "unearned increment"; they then provide for the estimation as of January 1, 1909, of the number of tons, barrels or other units contained in the mine or deposit and using this as the division factor find from the original capital cost, the cost per unit for depreciation purposes; then the deduction for the year equals the unit cost per ton (in the case of minerals) multiplied by the number of tons extracted.

We respectfully urge that the scheme thus adopted by the department was eminently fair to the government, for it assured to the government the receipt of taxes whenever in any year a mining company produced any ore which yielded anything over its initial cost per ton. It mattered not if a

company never got back even a fair percentage of its original capital expenditure; while it produced it was bound to pay. Whatever unfairness there may have been in the plan was borne by the company and not the government. The company had at all times to assume the risk, the rule being, pay as you go. Furthermore the most that the company could in any case claim for depreciation during its whole existing life was the cost value as of January 1, 1909, which constituted its depreciation limit.

Not only was the scheme thus devised by the Treasury Department eminently fair to the government but it was in complete harmony with the conclusions of the Court reached in the decision of the case of Mitchell Bros. Co. v. Doyle, 225 Fed. 437, hereinbefore cited and quoted at considerable length.

III. DEPARTMENT REGULATIONS ARE PRESUMPTIVELY CORRECT AND LEGAL.

We submit that when Congress confides the ascertainment of a "reasonable allowance for depreciation of property" to an executive department of the government, and that executive department solemnly adopts and promulgates rules and regulations which are eminently fair to the government and only questionably fair to the taxpayer; when the mining corporation in good faith enters into an exhaustive study and prolonged effort to comply

not only with such rules and regulations, but with any and every additional requirement reasonable or unreasonable imposed upon it as additional conditions by such executive department, as for example the condition that in order to obtain consideration it must show in its books and in its annual statements to stockholders the resulting impairment of its capital assets (as shown by our complaint); then we say, the taxpaying corporation is entitled at the hands of a Court to the usual presumption that the officers of the department in question have correctly construed the law and that such construction is as reasonably favorable to the government as the circumstances justify.

> U. S. v. Cerecedo Hermanos, 209 U. S. 338; 52 L. Ed. 821;
>
> Jacobs v. Prichard, 223 U. S. 200; 56 L. Ed. 405;
>
> U. S. v. Hammers, 221 U. S. 220; 55 L. Ed. 710.

We feel sure that Congress did not intend by the term "net income" to tax a company which makes a loss instead of a profit.

IV. THE REGULATIONS PROVIDE A FAIR MEASURE OF DEPRECIATION FROM EXHAUSTION; ARE HARMONIOUS WITH AND NOT REPUGNANT TO THE ACT.

We ask the Court to bear in mind that what the Statute speaks of is "depreciation of property" and not depreciation of *value* as reflected in the fluctuat-

ing stock markets for shares. It might be true as suggested by the Court in the original trial of the Stratton's Independence Limited case that in an undeveloped property, market value may be increased rather than decreased by discoveries of new ore deposits in the very act of mining known deposits, but this circumstance only enhances the market value and does not in any logical sense decrease the actual depreciation in the property itself to the extent of the ores being mined. We deem it fortunate indeed that our client, plaintiff in error herein, chose to rely upon literal and complete compliance with the department regulations, for this circumstance entitles us to ask at the hands of this Court a reversal of the decision of the District Court, unless this Court shall find that the regulations themselves are in some way repugnant to the Act of Congress. We believe that a careful consideration of the regulations found in the appendix hereto will convince this Honorable Court that the rules and regulations of the Treasury Department are well calculated to bring into the United States Treasury an even larger proportion of mine products than was intended by the framers of the Act, and as large a proportion of the mine product as comports with justice and fair treatment in a property, the very nature of which causes it at all times to be traveling toward its grave. In view of the fact that three of the Judges of the Supreme Court were of the opinion that the whole net value of ore proceeds

is a proper basis of depreciation, we fell assured that at least a majority of that Court would have concurred in the view that the cost value as provided by the Department rules are clearly deductable, and that is all that we contend for in the case at bar.

If there ever had been any doubt as to the reasonableness and fairness of the Treasury Department Regulations touching the matters herein discussed, such doubt has been finally removed by the new Act of Congress just approved, wherein the original regulation hereinbefore quoted has been specifically adopted and the later regulations found in the appendix to this brief have been applied with even more liberality in the new law than under the regulations themselves. The language of the new Act (in effect Sept. 9, 1916) is found in the Second Subdivision of Section 12, of the new Income Tax Act (page 40, Conference Committee Print, H. R. 16763). It reads as follows (being part of the allowed deductions):

> "All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use of employment in the business or trade; (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the

> mine of the product thereof which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided,* That when the allowance authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, Nineteen Hundred and Thirteen, the fair market value as of that date, no further allowance shall be made. * * *"

It will be seen from the language of the law just enacted that the Congress itself has thus legalized the deductions for depreciations from exhaustion of ore bodies even to a more liberal extent than was provided by the rules and regulations which were complied with by this plaintiff in error, and which had been promulgated under a plenary grant of power to the Treasury Department by the terms of the original Act.

We regret the length of this brief and wish to assure the Court that if it had seemed possible by a shorter method of treatment of the subjects discussed to have presented the argument adequately, we would have done so. We respectfully submit that the complaint of the plaintiff in error *does* state facts sufficient to constitute causes of action and that the defendant's demurrer should have been overruled; that the Court erred in sustaining the demurrer as to each of the causes of action stated therein and that the Court erred in dismissing the said cause and giving judgment of dismissal.

Wherefore we ask that the decision of the District Court be reversed and the cause be remanded for further proceedings.

Respectfully submitted,

HOYT, GIBBONS & FRENCH,
ALLEN G. WRIGHT,
Attorneys for Plaintiff in Error.

(APPENDIX FOLLOWS.)

APPENDIX

(Being Reprint of Sections 80 to 89, Inclusive, of the Regulations of the Treasury Department, Dated February 14, 1911, and Being Known Among the Printed Documents of the Treasury Depart-as T. D. 1675).

Depreciation in Minerals, Oils, Etc.

80. In case of corporations whose business consists in part or wholly of mining, producing, and disposing of deposits of nature (ores, coals, gas, petroleum, and sundry minerals) the conduct of such business will be understood to comprehend two classes of gains or losses, viz:

(a) The gain or loss resulting from the sale of capital assets, i. e., either the increment, or the loss, arising through possessing over a period of time the investment in the same.

(b) The trading or commercial gain attached to the conduct of the industry, the employment of working capital, the effort and risk involved.

81. In the ascertainment of net income deduction will be allowed for depreciation arising from exhaustion of deposits of ore, mineral, etc., and for depreciation and obsolescence of improvements, in accordance with general regulations respecting depreciation allowances, on the basis of the original capital investment cost of the properties concerned to the company reporting.

82. A further deduction will also be allowed, through not including the same at all in the item

of gross income (item 3, Form 637), for the unearned increment represented in such properties as at January 1, 1909, which will be determined in general as follows:

83. An estimate should be made as of January 1, 1909, of the fair market value at that date of the minerals, etc., in deposit. This estimate should be formed on the basis of the disposal value of the minerals in total and exclusive of value of improvements and development work. This valuation should also be reduced to a unit value—per ton, barrel, etc.

Note—Values as aforesaid should not be estimated on the basis of the assumed salable value of the output under current operative conditions, less the actual cost of production, because as hereinbefore stated, the selling price under such conditions comprehends a profit both for carrying the investment in minerals, improvements, and working capital, and for conducting operations in respect of production and disposal of product. The value to be determined as stated must be on the basis of the salable value of the entire deposit of the aggregate units of minerals considered en bloc if disposed of in that form. Nor must such valuation comprehend any speculative value which might attach to a sale of the minerals en bloc, i. e., a value which might be obtained on the ground that the future would develop a much greater reserve of mineral deposits than were believed to exist at the time estimate as of January 1, 1909, was formed.

Any value of this latter character would attach obviously to such additional reserves when developed in future.

84. The unit value as of January 1, 1909, ascertained as above outlined, would indicate the value to be attached at that date to the capital assets disposed of during any calendar year succeeding, and should be used in determining the unearned increment at January 1, 1909, which may be excluded entirely from the item of gross income, as before explained, in following manner, viz:

Value at January 1, 1909, determined in manner outlined, of minerals, etc., which may be removed and disposed of in any year subsequent thereto..........		$———
Less the following:		
(a) Proportion of depreciation charge applying to exhaustion of minerals disposed of, ascertained as first explained herein on basis of original cost..........................	$———	
(b) Royalty paid, if any on minerals disposed of........................	———	———
Balance, being unearned increment at January 1, 1909, to be excluded from gross income item..........		———

85. The precise detailed manner in which the estimate of value of minerals, etc., as at January 1, 1909, shall be formed, must naturally be determined upon by each corporation interested, but formal record of such estimates, together with all sustaining information, should be carefully filed so as to be readily accessible for reference. Values as stated, as determined at January 1, 1909, should be used in compilation in all subsequent years' excise-

tax returns. The question as to whether it subsequently develops the property possessed a greater quantity of mineral, etc., reserve than was in the aggregate estimated as of January 1, 1909, is immaterial. Any excess which may be developed will be considered as possessing the same value at January 1, 1909, as that which then may have been known to be in the property.

86. Each excise-tax return (Form 637) should be accompanied with memorandum setting forth the extent in amount of the exclusion made from the item gross income for unearned increment realized during the year, as above outlined.

87. As the amount to be deducted for depreciation (paragraph 2 preceding) is to be formed on basis of the estimated reserve of minerals, etc., it follows that if it develops such estimate is understated, the cost investment in the capital asset may be wholly extinguished before all mineral reserves are removed. When this is reached, further deductions for exhaustion of minerals should be discontinued but in such event it will be noted, the allowance for unearned increment which is to be excluded entirely from gross income will be correspondingly increased.

88. In case of corporations leasing mines and paying royalties on minerals, etc., removed, the royalties paid are to be treated as expenses and deducted in ascertaining net income, as provided in general regulations. Any leasehold investment which the operating corporations may have in such

properties, either through a payment originally made for acquirement thereof or for improvements made upon the property, to be accounted for in accordance with regulations governing depreciation allowances and disposition of capital assets.

89. In respect to properties of the character in question which may be acquired by a corporation after January 1, 1909, a deduction will be allowed only as to depreciation arising from exhaustion based on original cost; no exclusion from gross income can be made for unearned increment, as profit arising in sale of such capital assets applies wholly to the period subsequent to January 1, 1909.